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Supreme Court of the United States

OCTOBER TERM, 1946

No. 791

IN THE MATTER

of

THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Debtor.

GERALD AXELROD, *et al.*, constituting a Group of Individual Owners of the 4½% Convertible Gold Bonds of the above-named Debtor,

Petitioners,

v.

JOSEPH B. FLEMING and AARON COLNON, as Trustees of The Chicago, Rock Island and Pacific Railway Company, *et al.*,

Respondents.

REPLY OF PETITIONERS TO BRIEF OF METROPOLITAN LIFE INSURANCE COMPANY, *ET AL.* RESPONDENTS.

January 27, 1947

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INDEX

PAGE

Introductory Matter 1

ARGUMENT:

1. The petition is timely 3
2. The denial of a hearing on objections to the plan of reorganization is a live issue 4
3. The questions presented constitute valid grounds for the granting of a writ of certiorari 5

Conclusion 11

TABLE OF CASES

Bitker v. Hotel Duluth Co., 83 F. (2d) 721 (C. C. A., 8th Cir., 1936), aff'd 299 U. S. 577 ..... 2, 3

Blumgart v. St. Louis-San Francisco R'y Co., 94 F. (2d) 712 2

Continental Ill. Nat. Bank v. Chi., Rock Island & P. R'y Co., 294 U. S. 648 ..... 4, 9

Ecker v. Western Pac. R'y Co., 318 U. S. 448 8

Gardner v. State of New Jersey, U. S. Sup. Ct. Bulletin, Vol. 7, 613, 622 4

Gypy Oil Company v. Escoe, 275 U. S. 498 3

STATUTES

Bankruptcy Act, Sec. 77(d) 8

Bankruptcy Act, Sec. 77(e) 6

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REPLY OF PETITIONERS TO BRIEF OF METROPOLITAN LIFE INSURANCE COMPANY, *ET AL.* RESPONDENTS.

Introductory Matter

This reply brief is submitted pursuant to permission granted on January 13, 1947.

1. Respondents hasten to point out, in fact at the very opening of their brief (page 2 thereof) that the petitioners

are small investors as compared to some of the interests represented in these proceedings. Petitioners admit that they are small investors, yet nevertheless claim that they are entitled to equal protection of the laws. However, the respondents omit to state that while there is unanimity among the 4½% Convertible Bondholders who rejected the approved plan for reorganization of the Debtor as unfair and inequitable to them, First and Refunding Mortgage Bondholders to the extent of $19,500,000 personally appeared before the District Court on November 1, 1946 and orally voiced their opposition to the present approved plan of reorganization (p. 224 of minutes of that hearing). These bond holdings are at least several times in excess of the amount of bonds held by the respondent Metropolitan Life Insurance Company, the sponsor and proponent of the present plan.

2. In a footnote to the opening paragraph of their brief, Respondents allege that the interests of the Convertible Bondholders were actively and vigorously represented by the Chase National Bank as trustee under the indenture under which the bonds were issued. But the indenture trustee, as such, does not in these proceedings, *ipso facto,* represent the bondholders but rather its own interests as trustee. This trustee could not and did not vote to reject the present plan. The plan was rejected by the bondholders themselves.

Blumgart v. *St. Louis-San Franciso R'y. Co.,* 94 F. (2d) 712, 716 (C. C. A. 8th, 1938);

Bitker v. *Hotel Duluth Co.,* 83 F. (2d) 721, 723 (C. C. A. 8th, 1936) aff'd 299 U. S. 577.

Further, it should be remembered that this proceeding is essentially a contest between the secured bondholders and the Convertible Bondholders. Since up to the time it was permitted to foreclose its collateral, the Chase National Bank was substantially financially interested in the secured

issues, the vigorousness of its representation of the Convertible Bondholders throughout the period of formulating the plan may be looked upon with some suspicion.

"The trustee's judgment must not be substituted for that of the real creditors who are to be safeguarded in passing upon the question of whether a plan is fair and equitable." *Bitker* v. *Hotel Duluth* (*supra*), 83 F. (2d) 721 at p. 723.

3. In the footnote to page 3 of the Respondents' brief, mention is made of the petition for reconsideration by this Court in *Fleming* v. *Traphagen.* On January 13th, 1947, this Court announced its denial of that petition.

ARGUMENT

1. The petition is timely.

The Petitioners concur with Respondents that the governing principles of law are contained in the portion of the opinion in *Gypsy Oil Company* v. *Escoe,* 275 U. S. 498, quoted on page 6 of Respondents' brief.

The controlling factor is, of course, whether or not Petitioners' petition for rehearing was actually entertained by the Circuit Court. It is the Petitioners' view that their petition was so entertained.

This is based upon two grounds:

A. The petition for rehearing to the Circuit Court was *denied,* and not dismissed. A refusal to consider would have resulted in a dismissal. A denial presupposes a determination on the merits.

B. The Circuit Court stayed its mandates "until the disposition of the petitions for writ of certiorari in the Supreme Court of the United States". Hence, irrespective of the wording of the remainder of the Circuit Court's order, it is very evident that the

Circuit Court intended that its order be in form to permit review by this Court. Any other interpretation would render meaningless the second portion of the order of the Circuit Court.

2. The denial of a hearing on objections to the plan of reorganization is a live issue.

The question of the method of payment of the class of creditors known as the Chase Bank Group is interwoven into the very fabric of the reorganization. Payment of or settlement with one class of creditors must necessarily affect the rights of all other classes less adequately secured. The securities allotted to the Convertible Bondholders under the plan (*i. e.*, 4 shares of common stock for each $1,000 bond) have become diluted by reason of the illegal conduct of the Chase Bank Group, in that additional First Mortgage Bonds are now outstanding (see our Main Brief, p. 6; see also Respondents' Brief, p. 16, Table footnote A).

The judicial approval of the plan is, subject to variance on confirmation, intended to adjudicate the rights of the classes of creditors. Hence, the claim of the Convertible Bondholders, as a class, against the Chase Bank Group, as a class, was properly before the court upon the approval proceedings. For that reason it was not necessary for the Petitioners to prosecute the appeals mentioned on pages 10 and 13 of the Respondents' Brief. This Court has said that the securities of the debtor are the subject of this reorganization. *Continental Illinois National Bank & Trust Co.* v. *Chicago, Rock Island & P. R'y Co.*, 294 U. S. 648 (1935). And in *Gardner* v. *State of New Jersey*, U. S. Sup. Ct. Bulletin, Vol. 7, 613, decided January 20, 1947, it was held that the property of the debtor was in the custody of the court, irrespective of where the property may be located, and that the reorganization court has full jurisdiction over all questions respecting the title to such property.

Petitioners are not required to bring a petition for certiorari upon the entry of every intermediate order. Such interlocutory orders are, however, reviewable in the final order disposing of the litigation.

The claims of the Convertible Bondholders against the Chase Bank are, therefore, directly related to any fair and equitable plan of reorganization.

Page 12 of the Respondents' brief mentions an "*agreed* order" striking out in advance of a hearing thereon, certain of the Petitioners' allegations from their objections. Lest the term "agreed order" be misconstrued, Petitioners beg to point out that it was the *form,* not the substance, of the order that was agreed to. The order, as to the *form* of deletions to be made, was subject to a direction by the District Court to strike out those allegations. The direction of the District Court was not by consent of the Petitioners.

3. The questions presented constitute valid grounds for the granting of a writ of certiorari.

A. The Petitioners are accused of ignoring the allocation of $38,000,000 in cash to some of the creditors in their discussion of the method of re-capitalization. The Petitioners did not ignore this allocation, but merely recognized that the sum was not distributed as a bonus. It was accompanied by an equivalent reduction of claims against the debtor.

Surely, that does not mean that the net asset value of the estate has decreased by reason of said payment. Rather, it is definite proof that the higher earning potential of the debtor renders the railroad more valuable by reason of its demonstrated ability to pay off $38,000,000 on funded debt.

B. There is nothing in any of the cases cited on page 15 of the Respondents' brief which prevents a rejection of a valuation by the I.C.C. based upon an improper method of

valuation. On the contrary, these cases state that the method of evaluation, being a question of law, is subject to judicial review. Particularly is this so where the result is unfair and inequitable on its face.

Sec. 77(e) last paragraph of the Bankruptcy Act, as amended, specifies the method of valuation which I.C.C. must use.

C. The discussion, on page 15 of the Respondents' brief, concerning the issuance of $11,000,000 of new bonds and the use made of those bonds constitutes a completely fallacious argument on the question of valuation. The issuance of $11,000,000 of bonds and the receipt therefor of $11,000,000 in cash in the original plan would have added $11,000,000 to each side of the balance sheet and would not, therefore, affect the valuation of the debtor's property. The present changed plan provides for the issuance of $11,000,000 in bonds and the distribution of them to outstanding creditors, resulting in the reduction of claims in an equivalent amount. It was merely the substitution of one type of indebtedness for another. Thus it, too, had no effect on the value of the debtor's property. Therefore, it cannot be said that the change of plan constituted the slightest warrant for a decrease of valuation from $368,000,000 to $356,000,000.

D. The table shown on page 16 of Respondents' brief is based upon the valuations of the I.C.C. Hence, it is no more authoritative than the plan itself. To use it for the purpose of demonstrating the fairness of the plan is equivalent to hoisting oneself by his own bootstraps.

Further, the table is based upon face value of the securities to be issued. Yet, on page 21 of their brief, the Respondents concede that the securities in the plan, originally intended to be issued to holders of C & M bonds, would sell at far more than par. *This concession, in itself, is sufficient to warrant a revision of the plan.*

By the same reasoning, it is thus demonstrated, as Petitioners have contended, that the General Mortgage with 112% of their claims satisfied under this approved pre-war plan are also overcompensated.

E. Respondents accuse the Petitioners of misquoting or misinterpreting the record in contending that the I.C.C. stated that payment of the R.F.C. claims would necessitate material modification in the plan. A re-reading of the pertinent portion of the record indicates no such misquoting or misinterpretation. That is what the Commission said. Petitioners believe the Commission meant what it said.

F. Respondents' entire argument concerning Petitioners' *Specification 5* (pages 16-18 of their brief) is based upon the alleged deficiency. Petitioners claim that, in view of the changed situation showing indisputable tremendous cash and securities accumulations and sharp reduction of funded debt and annual, fixed charges, the Commission should be given the opportunity to determine now whether such deficiency does actually exist. It is also based upon the fallacious theory that funds earned by the debtor during the period of reorganization belongs to the secured creditors. Petitioners claim that net profits, as distinguished from moneys obtained from the sale of a mortgaged asset, belong to the general fund, and as such, are subject to be ratably shared by all creditors, secured or unsecured.

G. The Respondents' brief assumes that the Petitioners complain of the changes made in the plan by the Commission after certification of it by the Commission to the Court. On the contrary, Petitioners' objection is that material changes were made by the Court, not the Commission, contrary to the provisions of Section 77 of Bankruptcy Act, thereby denying the Commission the opportunity of revising the plan in the light of such changes.

The indisputable fact is that an entire class of creditors consisting of the Chase Bank and the R.F.C. loans were eliminated by the District Court. This is contrary to the terms of the plan as contemplated by the Commission's report (R. 234) and requires recasting by the Commission.

It is true that petitioners, the Convertible Bondholders Group, made more proposals than the one to pay off the Bank-R.F.C. loans (R. 230). The Commission speaks of all together as "Convertible Bondholders Group's *proposals*". Similarly, it refers to the "Debtor's *proposals*". It discusses and disapproves these proposals one by one until only the proposal to pay the loans is left. In discussing that the Commission said (R. 234):

> "The approval of either the debtor's *proposal* or the Convertible Bondholders' Group's *proposal* would necessitate material modification in the plan and, in our opinion, is not warranted." (Italics supplied.)

Neither Article XVII nor Article XXII of the plan can be construed to authorize the Court to vary the plan as it did. Article XVII makes provision for payments on claims. It was never intended to cover payment of an entire creditor class. It speaks of reducing the amount of the claim, not eliminating it entirely (R. 28-29). It may be that the Commission had the R.F.C. in mind when it considered Article XVII. But its later discussion (R. 256-257) clearly indicates partial payments are intended, not full payment and total elimination of an entire class of creditors. The saving clause, Article XXII (R. 30) quoted on page 21 of Respondents' brief, permits the Court to make minor adjustments to carry out the plan as approved by the Commission. It certainly is not intended to authorize the Court to make basic changes in the plan itself. In fact, any such delegation of authority would violate the provisions of the Bankruptcy Act and would be illegal.

> Bankruptcy Act, Sec. 77, Subsection (d);
> *Ecker* v. *Western Pac. R'y. Co.*, 318 U. S. 448.

H. Respondents' brief, pages 21 and 22, alleges that the Circuit Court did not deny itself the power to review the valuation of the Commission. Attention is respectfully directed to the following portion of the Opinion of the Circuit Court (R. 347):

> "The debtor, appropriately, does not question the valuations of the Commission. It contends, however, that the Commission erred as a matter of law when it reduced the total capitalization from $368,127,410 to $356,117,327 in the modified plan here on review. It says that because the Commission determined the debtor's assets at one figure, it is precluded from reconsideration unless there has been a new determination of the fair value of assets. Otherwise, the debtor argues, the fund to be divided among the creditors could be reduced indiscriminately.
>
> "In so arguing, it seems to us that the debtor overlooks the point that any determination of total capitalization is in itself a valuation *which, concededly, is not subject to review.*" (Emphasis supplied.)

I. Cash distribution was made to the Convertible Bondholders to the extent of $406,482 out of a total of $50,421,522 in cash and new first mortgage bonds or less than 4/5ths of 1% of the securities and cash available. Even accepting the basis of Respondents' argument, to wit, that they are entitled to 90% of all cash earned by the trust estate, it becomes obvious by the Respondents' own admission that this formula was not followed (Respondents' Brief, pp. 24-25).

However, the earnings of the estate are part of the general fund of the Debtor and hence, not allocable only to senior debt. In fact, under the decision of this honorable Court in *Continental Illinois National Bank & Trust Co.* v. *Chicago, Rock Island & Pacific Railway Co.*, 294 U. S. 648 (1935), it was specifically held that Respondents have no *lien* on property of the Debtor in a plan of reorganization

but only the right to compensation in new securities. But even if such a lien did exist it would not extend to earnings made possible by the mortgaged property because the earnings generated by the mortgaged property do not dilute or depreciate the value of the security.

J. The answer relating to *Specification 10* (Respondents' Brief, p. 25), is also fallacious. Refusal to consider Petitioners' petition for rehearing by the Circuit Court of Appeals is discretionary, but as we have shown above (p. 3), the petition was, in fact, entertained and not dismissed but only denied. Moreover, stay of mandate to permit review by this honorable Court was intended and specifically provided for by the same order of the Court.

The cancellation of hearings by the Commission pending the appeal from the order remanding the plan, does not affect the basic fact that the last judicial appraisal of the plan resulted in a finding of unfairness and inequity recognized by the District Court and the Commission as reflected in the District Court's order denying confirmation of the plan and the Commission's order reopening this proceeding and assigning it for public hearing for the consideration of modifications to, or the presentation of, new plans. That public hearing has not been held due to Respondents' periodic petitions for postponement.

It is not the intention of the Petitioners to delay the proceedings uselessly. Actually, a constructive proposal which will permit payment of the General Mortgage creditors and full satisfaction of the remaining unsatisfied senior claims has already been submitted by Petitioners and is on file with the Commission.

Finally, this honorable Court's attention is directed to the fact that *the basis of the plan is already materially changed by reason of the substantial reduction of annual fixed charges provided for in the plan* (*Petitioners' Brief, p. 26*). This is an actual and not a theoretical situation

upon which Petitioners fail to comment and which is unanswerable and must be recognized by this honorable Court.

The physical existence of huge amounts of cash and securities in the trust estate has not and cannot be denied.

In identical circumstances the *senior* creditors in the Missouri-Pacific Railroad reorganization have this day petitioned the Circuit Court of Appeals, 8th Circuit to remand an approved plan of reorganization to the Interstate Commerce Commission for revision.

The present Rock Island plan should, therefore, be remanded and revised to permit increased participation by junior creditors on a basis which is just and fair and equitable.

CONCLUSION

The petition for writ of certiorari and for the relief sought by Petitioners should be granted.

Dated, January 27, 1947.

Respectfully submitted,

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